

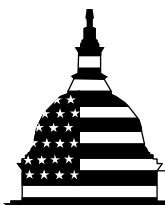


Report to the Committee on Armed
Services, U.S. Senate

December 2012

DEFENSE CONTRACTING

DOD Initiative to Address Audit Backlog Shows Promise, but Additional Management Attention Needed to Close Aging Contracts



G A O

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DEFENSE CONTRACTING

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Why GAO Did This Study

DOD has a large volume of contracts that have not been closed on time. Closing a contract includes tasks such as verifying that the goods and services were provided and making final payment to the contractor. Closing contracts within required time frames can limit the government's exposure to certain financial risks. One reason why some contracts are not being closed is the large backlog of incurred cost audits that must first be completed. These audits, conducted by DCAA, ensure that the costs contractors have incurred are permissible under government regulations.

The Senate Armed Services Committee report accompanying the National Defense Authorization Act for Fiscal Year 2012 directed GAO to review the criteria and procedures for conducting incurred cost audits, among other things. In response, GAO assessed (1) efforts to reduce the backlog of incurred cost audits and (2) the challenges DOD faces in addressing the contract closeout backlog. GAO reviewed DCAA's policies and procedures for incurred cost audits; analyzed data on the audit and contract closeout backlogs; and interviewed officials in the military departments and agencies.

What GAO Recommends

GAO is recommending that DCAA develop a plan to assess its incurred cost audit initiative; that DCMA improve data on over-age contracts; and that the military departments develop contract closeout data and establish performance measures. DOD concurred with the recommendations and identified ongoing and planned actions to address them.

View [GAO-13-131](#). For more information, contact Timothy J. DiNapoli, (202) 512-4841 or dinapolit@gao.gov.

What GAO Found

To reduce the backlog of incurred cost audits, the Defense Contract Audit Agency (DCAA) implemented an initiative to focus its resources on auditing contractors' incurred costs that involve high dollar values or are otherwise determined to be high risk. Incurred cost audits are conducted on a contractor's annual proposal that includes all costs incurred on certain types of contracts in that fiscal year. Under the initiative, DCAA raised the dollar threshold that triggers an automatic audit on a contractor's incurred cost proposal from \$15 million to \$250 million, revised the criteria used to determine a proposal's risk level, and significantly reduced the number of low risk audits that will be randomly sampled. This initiative appears promising, and DCAA plans to track certain characteristics, such as the number of risk determinations made and audits completed. But DCAA has not fully developed the measures by which it will assess whether the initiative reduces the backlog in a manner that protects the taxpayers' interests. Specifically, DCAA does not have a plan for how it will determine whether key features of the initiative, such as the revised risk criteria and the revised sampling percentages, should be adjusted in the future. By 2016, DCAA estimates it will reduce the backlog and reach a steady state of audits, which it defines as two fiscal years of proposals awaiting review. DCAA's ability to achieve this goal will depend on a number of factors, including the number of proposals determined to be high risk, which as of September 2012 was about two-and-a-half times more than anticipated.

Reducing the backlog of incurred cost audits will ease one obstacle to closing over-age contracts, but other obstacles, such as limited data and performance metrics, must still be overcome. The military departments have limited data on the extent and nature of their contract closeout backlog, and the Defense Contract Management Agency (DCMA)—which performs contract administration services for the Department of Defense (DOD)—is missing information that would allow it to identify contracts that it could act on. Such data can cue agencies on how to identify or tailor approaches to address the backlog. Further, the military departments generally do not have performance metrics to measure progress in closing out contracts. The Army recently announced a goal of closing over 475,000 contracts by September 2014; however, it does not yet have the information necessary to know if it can reach this goal and does not have an implementation plan. The Navy and the Air Force had not established any department-wide performance metrics for contract closeout. In contrast, DCMA has established two agency-wide performance metrics related to contract closeout that are regularly monitored. While many officials said contract closeout was not a priority, GAO found some local contracting activities taking action to bring attention to contract closeout.

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Abbreviations

ADV	Auditable Dollar Value
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DFAS	Defense Finance and Accounting Services
DPAP	Defense Procurement and Acquisition Policy
DOD	Department of Defense
FAR	Federal Acquisition Regulation
MOCAS	Mechanization of Contract Administration Services

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United States Government Accountability Office
Washington, DC 20548

December 18, 2012

The Honorable Carl Levin
Chairman
The Honorable John McCain
Ranking Member
Committee on Armed Services
United States Senate

The Department of Defense (DOD) obligated more than \$3 trillion over the last 10 years on contracts to acquire goods and services needed to support its mission. Once performance on these contracts has been completed, they must be closed as the final step in the acquisition process. DOD currently has a large backlog of both flexibly priced and firm-fixed-price contracts¹—reportedly numbering in the hundreds of thousands—that have not been closed within the time frames required by federal regulations.² Closing contracts within required time frames can help to limit the government’s exposure to certain financial risks by identifying and recovering improper payments and avoiding paying interest fees when the government does not pay contractors on time. Timely closeout also ensures that DOD deobligates and uses unspent funds from completed contracts before the funds are canceled and returned to the U.S. Department of the Treasury.³ In addition, closing a contract years after the performance is complete can present challenges because key documentation and contracting personnel with firsthand knowledge of the contract may no longer be available.

¹A firm-fixed-price contract provides for a contract price that is generally not subject to any adjustment on the basis of the costs a contractor incurs while performing the contract. In contrast, flexibly priced contracts include contract types where the price may be adjusted based on actual costs incurred. The DCAA Contract Audit Manual defines flexibly priced contracts to include all cost-type, fixed-price-incentive, and fixed-price-redeterminable contracts; orders issued under indefinite delivery contracts where final payment is based on actual costs incurred; and portions of time-and-material and labor hour contracts.

²Federal Acquisition Regulation (FAR) § 4.804-1(a)(2) and (3).

³An agency can use funds for up to 5 years after they expire to pay for authorized increases to existing obligations made from the same appropriation. Any funds remaining after the 5-year period are considered canceled and must be returned to U.S. Department of the Treasury. If closeout does not take place until after they are canceled, and the agency identifies a need for the government to pay the contractor for an unanticipated cost, the government must use other funds that are currently available.

One of the key factors affecting DOD's ability to close out flexibly priced contracts is the Defense Contract Audit Agency (DCAA) backlog of approximately 25,000 incurred cost audits as of the end of fiscal year 2011, some dating as far back as 1996. This backlog represents hundreds of billions of dollars in unsettled costs, and according to DCAA has quadrupled over 10 years. DCAA conducts incurred cost audits to identify whether all costs incurred on flexibly priced contracts are allowable, allocable, and reasonable—information that contracting officers need to close flexibly priced contracts. Contracting officers also use information from incurred cost audits to help determine final indirect cost rates for a contractor. Indirect cost rates are a mechanism for establishing the proportion of indirect costs—or costs that are not directly attributable to a specific project or function such as a contractor's general and administrative expenses and health benefits—that can be charged to a contract. Because of the need to settle indirect cost rates, flexibly priced contracts can be more difficult and time-consuming to close than firm-fixed-price contracts. One tool for expediting the closeout of flexibly priced contracts is a process known as the quick closeout procedure. The quick closeout procedure can only be applied to certain contracts where the unsettled contract costs are considered relatively insignificant and can allow for closing these contracts without an incurred cost audit.

The Senate Armed Services Committee report accompanying the National Defense Authorization Act for Fiscal Year 2012 directed GAO to review DCAA's criteria and procedures for conducting incurred cost audits and recommend steps DCAA could take to reduce the backlog and to consider the feasibility and advisability of three options aimed at reducing the contract closeout backlog.⁴ The three options we were asked to consider were (1) restoring the authority of the head of an agency to close out a contract that is administratively complete, was entered into 10 or more years ago, and has an unreconciled balance of less than \$100,000; (2) authorizing the contracting officer, in consultation with DCAA, to waive the requirement for an incurred cost audit in the case of a low risk, low-cost contract; and (3) authorizing the contracting officer to waive final payment in a case where the contractor has gone out of business and cannot be reached. It also asked us to assess the efficacy of a May 2011 change to the Federal Acquisition Regulation (FAR) that was intended, in part, to increase the use of quick closeout procedures. In response, this

⁴S. Rep. 112-26, at 153 (2011).

report addresses (1) DCAA's efforts to reduce the backlog of incurred cost audits, and (2) the challenges DOD faces in addressing the contract closeout backlog. Included within the scope of the second objective was a consideration of the three options outlined in the Committee report as well as the use of quick closeout procedures.

To assess DCAA's efforts to reduce the backlog of incurred cost audits, we reviewed applicable federal regulations and DCAA's Contract Audit Manual to identify its criteria and procedures for conducting incurred cost audits and obtained and reviewed data on DCAA's incurred cost audit backlog. We also collected and reviewed documentation on DCAA's processes and criteria for conducting incurred cost audits, such as agency memorandums, guidance, and forms for documenting risk determinations. We interviewed senior DCAA officials and DCAA auditors from three field offices that performed a high volume of risk determinations to obtain a better understanding of the process and considerations by which they determine the risk associated with a contractor's incurred cost proposals.⁵ We also interviewed officials at Defense Procurement and Acquisition Policy (DPAP) and the Defense Contract Management Agency (DCMA) to get their perspective on DCAA's efforts to reduce the backlog of incurred cost audits.

To identify the challenges DOD faces in addressing the contract closeout backlog and to assess the efficacy of the May 2011 change to the FAR pertaining to quick closeout procedures, we reviewed federal regulations as well as agency guidance and policies on contract closeout and quick closeout procedures, and GAO's standards for internal controls in the federal government.⁶ We collected and analyzed available data and documentation on over-age contracts—or contracts that have not been closed in the time frames prescribed by federal regulations—from DCMA headquarters, the two DCMA contract management offices with the largest volume of over-age contracts, military department headquarters (Army, Navy, and Air Force), five commands, and nine contracting offices within those commands. The commands and contracting offices were selected based on factors such as the total reported volume of over-age

⁵The FAR refers to these proposals as "final indirect cost rate proposals." FAR 42.705-1(b)(1).

⁶GAO, *Internal Control: Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November, 1999).

contracts. We also interviewed officials at DPAP, DCAA, DCMA, the Defense Finance and Accounting Services (DFAS); Army, Navy, and Air Force officials at headquarters and the commands, as well as individual contracting offices. We interviewed one contractor and two contractor industry associations to obtain their views on the incurred cost audit and contract closeout backlogs. To address the options outlined in the Committee report, we reviewed applicable laws, related agency policies and guidance, and solicited input about the availability and potential usefulness of the options in our interviews with representatives from DCAA; DCMA; military department headquarters, commands, and contracting offices; the military departments' general counsel; DFAS; and contractor representatives. Appendix I provides additional details on our scope and methodology.

We conducted this performance audit from February 2012 to December 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Closing out contracts involves a number of tasks, such as verifying that goods or services were provided, making final payment to the contractor, and deobligating excess funds. A contract is generally eligible to be closed once all option provisions have expired, the contractor has completed performance, and the government has accepted the final delivery of goods or services, or when the government has provided the contractor a notice of complete contract termination. From this point, contracts are considered physically complete, and should be closed within time frames set by the FAR—6 months for firm-fixed-price contracts and 36 months for flexibly priced contracts. The FAR prohibits the closing of contract files if the contract is in litigation, under appeal, or where the contract is being terminated and all termination actions have not been completed.⁷ Contract documents can be stored and retained after the contracting officer signs and files the contract completion statement.

⁷FAR § 4.804-1(c)(1) and (2).

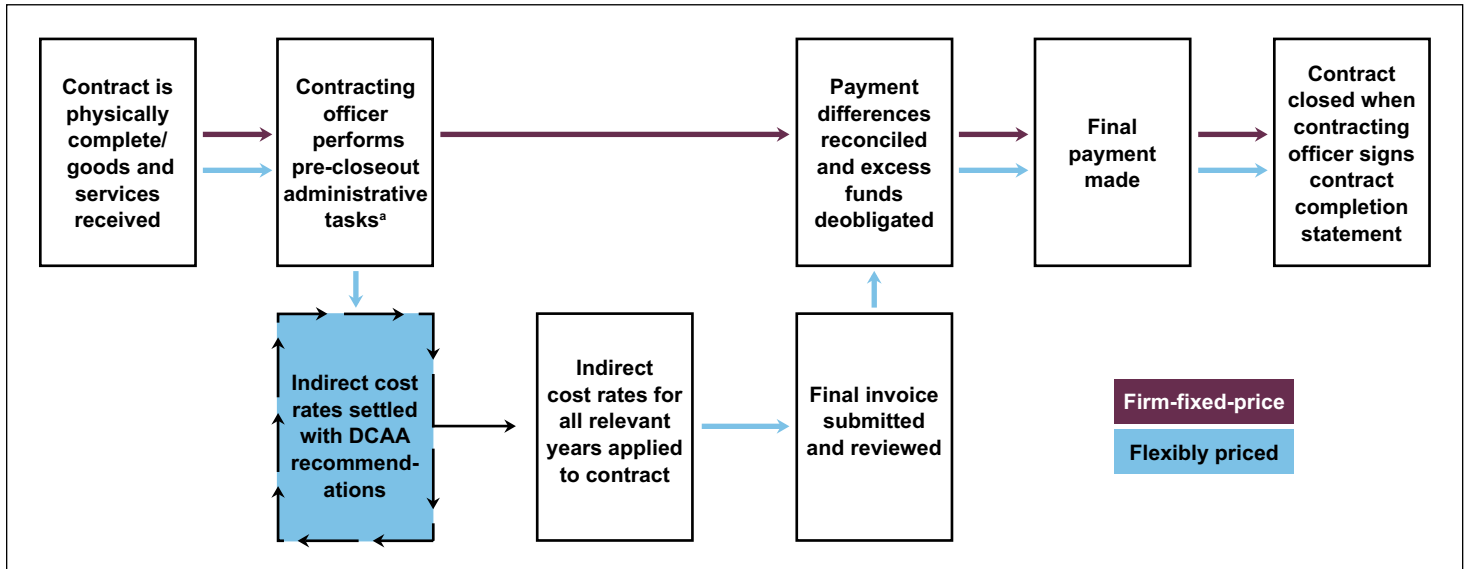
Additional time is allowed for the closeout of flexibly priced contracts because there are additional steps necessary to close out these types of contracts (see figure 1). Specifically, closing these contracts generally requires an audit and settlement of the contractor's final indirect cost rates. Contracting officers and DCAA need to ensure all costs incurred by the contractor and charged to the government are allowable, allocable, and reasonable. Contracting officers also need to establish final indirect cost rates based on the contractor's incurred costs, which determine, in part, the contractor's final payment on flexibly priced contracts.⁸

⁸Indirect cost rates can also be auditor determined. FAR § 42.705-2.

Figure 1: DOD Contract Closeout Process

Interactive Graphic

To highlight firm-fixed-price closeout process, roll mouse over legend. Click on blue box to go to figure 2, DCAA's incurred cost audit process.



Source: GAO analysis of federal and DOD regulations and guidance.

^aCertain low-dollar, fixed-price contracts are closed using a more simplified process.

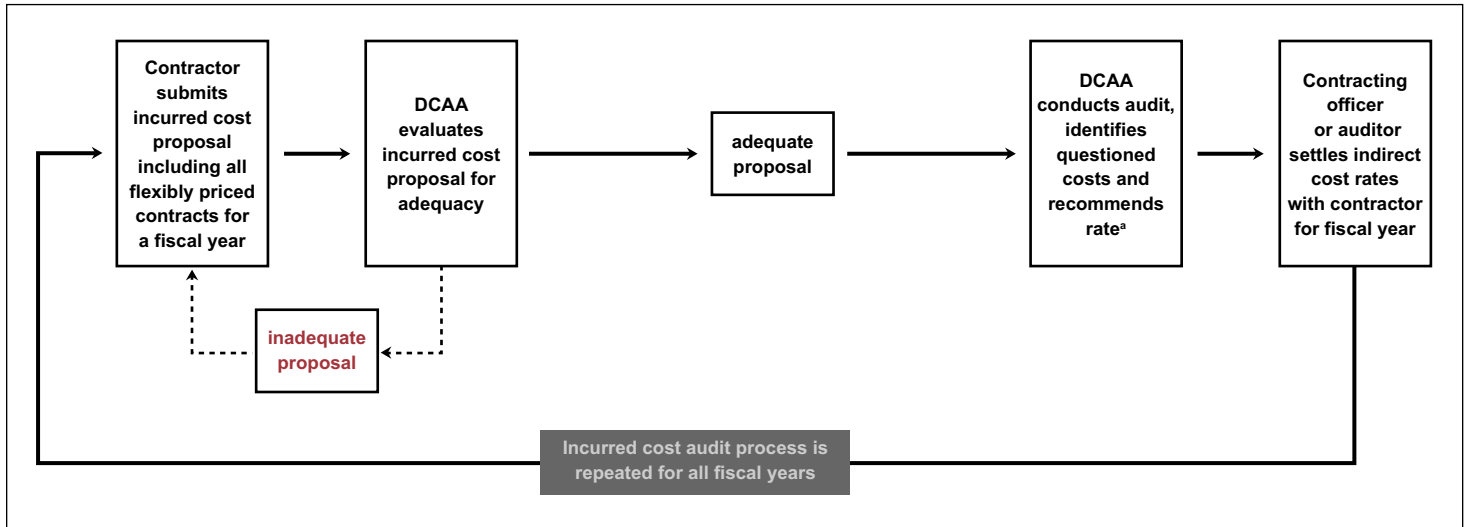
Contractors are required by the FAR to submit proposals that include information on all of their flexibly priced contracts in a fiscal year.⁹ Once submitted, DCAA audits the proposal to determine if the costs incurred are reasonable, allowable and allocable to government contracts (see figure 2 for incurred cost audit process). There is not a one-to-one relationship between an incurred cost audit and an individual contract. In a single fiscal year, a contractor may incur costs on multiple flexibly priced contracts, and all of these contracts would be included in the proposal. The total value of the proposal, called the auditable dollar value (ADV), is the sum of all the costs on flexibly priced contracts for that contractor during the fiscal year. Additionally, since the period of performance on an individual contract may span several fiscal years, several audits may need to be conducted to provide the information necessary to close one flexibly priced contract. Further, DCAA may assess a contractor's incurred cost proposal as inadequate for a variety of reasons, for example if the proposal is not certified or contains math errors, and request that the contractor review, revise, and resubmit its incurred cost proposal.

⁹FAR § 16.307 directs the contracting officer to insert FAR Clause 52.216-7 in a contract when a cost-reimbursement contract or a time-and-material contract is contemplated. The clause addresses the requirement for a contractor to submit an adequate final indirect cost rate proposal.

Figure 2: Incurred Cost Audit Process

Interactive Graphic

To return to figure 1, click the arrow. ◀



Source: GAO analysis of federal and DOD regulations and guidance.

^aNot all proposals are selected for audit. See figure 3 for additional details on selection process.

The responsibility for closing out a contract resides with the DOD contracting officer within the military department or other defense agency that awarded the contract. The contracting officer may, however, delegate certain administrative responsibilities, including contract closeout, to DCMA, which provides contract administration services to DOD.¹⁰ DFAS also plays a role in activities related to contract closeout, such as paying final vouchers, and, when needed, resolving unreconciled balances on a contract.¹¹

Quick Closeout Procedures

To facilitate contract closeout of flexibly priced contracts, federal regulations authorize the use of quick closeout procedures, by which a contracting officer can negotiate the settlement of direct and indirect costs on a specific contract, task order, or delivery order without waiting for the determination of final indirect cost rates for the contractor's fiscal year.¹²

To use the quick closeout procedure, several conditions must be met. For example, the amount of unsettled direct and indirect costs to be allocated to the contract, task order, or delivery order must be relatively insignificant—which is defined as costs that do not exceed the lesser of \$1,000,000 or 10 percent of the total contract, task order, or delivery order amount. The contracting officer also must perform a risk assessment and determine that the use of the quick closeout procedure is appropriate and consider such factors as the contractor's accounting, estimating, and purchasing systems, and any concerns of cognizant DCAA auditors. When the quick closeout procedure is used for a contract, determinations of final indirect costs are considered binding for the specific contract covered, but the rates used during this process are not considered binding when establishing the final indirect cost rates for other contracts.

DCMA has issued a memorandum authorizing its contracting officers to close specific contracts prior to the establishment of indirect cost rates regardless of the dollar value of the contract or the percent of unsettled

¹⁰FAR § 42.202(a).

¹¹The term "unreconciled balances" can refer to situations in which the payments recorded for a contractor's invoices do not agree with the obligations recorded on its contracts and the different amounts must be reconciled.

¹²FAR § 42.708.

direct and indirect costs allocable to the contract. This memorandum—known as a class deviation from the FAR because it allows for actions that are inconsistent with the regulation—was signed by the agency director in October 2011 and extends through September 2013. According to DCMA officials, DCMA has had similar deviations in place since 1999. The policy allows a DCMA contracting officer to waive the requirement for an incurred cost audit, in consultation with DCAA, when a compelling reason exists. DCMA guidance indicates that compelling reasons may include contracts with funds at risk of canceling, contracts that have been over-age for 6 or more years, and contracts where a contractor’s historical final indirect cost rates have been fairly consistent with proposed certified final indirect cost rates.

Prior Work

Our prior work has highlighted challenges at DCAA as well as some of DOD’s challenges in closing out contracts, particularly those awarded to support operations in Iraq and Afghanistan. In 2009, we found problems with DCAA’s audit quality nationwide, including insufficient testing of contractors’ support for claimed costs.¹³ We recommended that DCAA develop a risk-based contract audit approach across the agency that included identification of resource requirements. DCAA officials reported that as a result of our findings, it now requires more testing and stricter compliance with government auditing standards, which adds to the amount of staff time required to complete each audit. In September 2011, we reported that DOD’s ability to close the contracts it awarded to support efforts in Iraq was hindered by several factors, including the failure to plan for or emphasize the need to close these contracts until reconstruction efforts were well under way.¹⁴ We also found that DOD commands prioritized contract awards over other activities and DOD does not have visibility into the number of Iraq contracts eligible for closeout. We also reported that DOD’s efforts to close its large, cost-type contracts was hindered by staffing shortages at DCAA and unresolved issues with contractors’ cost accounting practices. We made recommendations to ensure DOD has sufficient resources to close its Iraq and Afghanistan

¹³See GAO, *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, [GAO-09-468](#) (Washington, D.C.: Sept. 23, 2009).

¹⁴GAO, *Contingency Contracting: Improved Planning and Management Oversight Needed to Address Challenges with Closing Contracts*, [GAO-11-891](#) (Washington, D.C.: Sept. 27, 2011).

contracts and to better plan for and improve visibility of closeout efforts in future contingencies. In May 2012, DOD amended the Defense Federal Acquisition Regulation Supplement to require heads of contracting activities to monitor and assess on a regular basis the progress of contingency contract closeout activities and take appropriate steps if a backlog occurs.

Our prior work has also identified some challenges at DCMA in relation to establishing indirect cost rates and workload. In November 2011, we reported that DCMA has been increasing its workforce and rebuilding key skills sets that had atrophied in recent years, such as cost and pricing capabilities.¹⁵ According to DCMA, loss of this skill set meant that many of the agency's pricing-related contract administration responsibilities, such as establishing final indirect cost rates, were no longer performed to the same level of discipline and consistency as in prior years. As a result, DCMA stated that DOD's acquisitions were subjected to unacceptable levels of cost risks. Both DCMA and DCAA have been increasing their workforce in recent years to address some of the challenges faced by the agencies.

The challenges faced by DOD in closing out contracts are not recent phenomena. For example, in 2001, the DOD Inspector General issued a report that found weaknesses in the closeout process, including inadequate monitoring of contracts that could be closed, inattention to closure requirements, erroneous data about contracts available for closure, lack of coordination, lack of sufficient funding, a shortage of personnel, and untimely contractor input.¹⁶ The Inspector General reported that DOD made progress by closing about 30,000 contracts from February 2000 to March 2001, though over 26,000 became over-age during that same period.

¹⁵GAO, *Defense Contract Management Agency: Amid Ongoing Efforts to Rebuild Capacity, Several Factors Present Challenges in Meeting Its Missions*, [GAO-12-83](#) (Washington, D.C.: Nov. 3, 2011).

¹⁶DOD Office of the Inspector General, *Closing Overage Contracts Prior to Fielding a New DOD Contractor Payment System*, D-2002-027 (Arlington, Va.: Dec. 19, 2001).

DCAA Implemented Initiative to Focus on High Risk Incurred Cost Proposals, but Has Not Yet Fully Developed Measures to Evaluate the Initiative's Results

To address the backlog of incurred cost audits, DCAA implemented a new, risk-based initiative in 2012 which focuses DCAA's resources on incurred cost proposals that have high dollar values or are determined by auditors to be high risk. In doing so, DCAA will significantly reduce the number of audits performed on incurred cost proposals that are determined to be low risk. Under its risk-based initiative, DCAA raised the threshold by which an incurred cost audit is automatically performed on a contractor's incurred cost proposal, revised the criteria used to determine a proposal low risk, and decreased the percentages of low risk proposals that will be randomly selected for audit. DCAA plans to track certain data to help assess progress in eliminating the backlog, but DCAA has not fully developed measures to determine whether key features of the initiative, such as revised criteria for determining a proposal is low risk and revised sampling percentages, should be adjusted in the future. Further, DCAA estimates it will reach a steady state of audits, which DCAA defines as two fiscal years of proposals awaiting review, by 2016, but whether DCAA will achieve its goals will depend on a number of factors, including the number of proposals determined to be high risk and the completion of subsequent audits.

DCAA's Initiative Prioritizes High Risk Incurred Cost Proposals for Audit

In 2012, DCAA began implementing a new, risk-based approach that is expected to shift DCAA's resources to focus on incurred cost audits involving high-dollar value and high risk proposals. DCAA officials told us that in 2011, DCAA recognized that the number of audits that needed to be conducted exceeded the capacity of DCAA's staff to do so. Accordingly, DCAA reported that incurred cost audits were not prioritized in fiscal year 2011 since they did not provide as many financial benefits as other audits, such as forward pricing audits, which are used to determine fair and reasonable rates for the award or modification of a contract.

In developing the initiative, DCAA performed an analysis of which audits provided financial benefits by comparing how much money was saved or recovered by various types of audits (such as incurred cost and forward pricing audits) to how much money was invested in performing those audits. As a part of this analysis, DCAA officials found that the agency spent more in terms of staff resources to conduct incurred cost audits on proposals valued at less than \$1 million than the financial benefits derived from the audits. DCAA's analysis also determined that proposals valued over \$1 million have provided more benefits than the cost to conduct them, with the benefits generally increasing as the value of the proposal increased.

Raised Threshold by Which
Proposals Automatically
Qualify for Audit

DCAA's risk-based initiative includes key changes to its criteria and procedures that will decrease the number of audits conducted. These changes include (1) raising the threshold by which proposals automatically qualify for audit, (2) revising the criteria used to determine a proposal low risk, (3) lowering the percentage of low risk proposals to be randomly selected for audit, and (4) eliminating further review of proposals not selected for audit, and revising its adequacy review procedures to be more comprehensive. In addition to the changes to criteria and procedures, DCAA officials noted they plan to increase their staffing levels from 4,900 employees in 2011 to 5,600 by 2016. DCAA provided refresher training to its staff, and created 17 dedicated teams to incurred cost audit work.

DCAA raised the threshold above which an audit is required based on ADV from \$15 million to \$250 million, thereby decreasing the number of proposals automatically qualifying for audit from 5,194 to 659, based on the backlog as of the end of fiscal year 2011 (see table 1). Proposals under the \$250 million threshold will not be audited unless they are determined to be high risk or randomly selected for audit.

Table 1: Incurred Cost Audit Backlog as of the End of Fiscal Year 2011

Auditable dollar value	Number of proposals^a	Total auditable dollar value (in billions)
\$1 million or less	9,040	\$4.0
>\$1 million to \$15 million	10,488	\$48.8
>\$15 million to \$50 million	2,884	\$71.0
>\$50 million to \$100 million	945	\$56.4
>\$100 million to \$250 million	706	\$79.8
More than \$250 million	659	\$313.4
Total	24,722	\$573.3

Source: DCAA.

^aIncludes 2,431 non-DOD proposals. DCAA conducts audits on a reimbursable basis for non-DOD agencies, and is working with these agencies to determine their level of participation in the initiative. According to DCAA, the backlog includes all proposals that are due to be audited, whether they have been submitted to DCAA by the contractor or not, and whether they have been determined adequate or not.

Revised Criteria Used to
Determine a Proposal to Be
Low Risk

In conjunction with raising the threshold by which incurred cost proposals were automatically selected for audit, DCAA revised two of the three criteria that a contractor's incurred cost proposal under the \$250 million threshold must meet to be determined low risk (see table 2). For example, under DCAA's prior criteria, DCAA must have performed an incurred cost

audit within the past three years; under the new initiative, for proposals \$100 million or under, the time frame for conducting the last incurred audit was eliminated—the requirement is now that the contractor has had at least one incurred cost audit. These changes will increase the potential number of contractor proposals that are eligible for low risk determinations. The other criterion—audit leads or other significant risks—did not change.¹⁷ However, DCAA did provide several examples of the types of risks that should be considered under this criterion, such as known business system deficiencies or risks identified by the contracting officer.

Table 2: Key Changes to DCAA’s Incurred Cost Audit Low Risk Criteria

Risk factor	Previous criteria (applied to proposals under \$15 million ADV)	Revised criteria (applied to proposals under \$250 million ADV)
History of incurred cost audits	At least one incurred cost audit every 3 years	At least one incurred cost audit ^a
Previous questioned costs	Below \$10,000	Below thresholds ranging from \$15,000 to \$100,000 based on ADV
Audit leads or other significant risks	No relevant risk factors	No changes

Source: GAO analysis of DCAA guidance and documentation.

^aProposals with an ADV of greater than \$100 million to \$250 million must have an incurred cost audit at least once every three years. For all other proposals, auditors will rely on their professional judgment to determine if a contractor’s prior incurred cost audit history is sufficient.

Reduced the Percentage of Low Risk Proposals Sampled for Audit

Once risk has been determined, those proposals that are determined to be low risk will be randomly sampled at DCAA’s five regional offices based on the proposal’s ADV, but now at a lower percentage than before. Currently, between 1 and 20 percent of low risk proposals are sampled depending on ADV, whereas under the previous procedure 33 percent of low risk proposals were sampled (see table 3).

¹⁷DCAA auditors document audit leads in their files when an issue arises that an auditor feels needs to be addressed, but is not an area within the scope of the current audit. As a part of their risk assessment of the incurred cost proposal, DCAA auditors are responsible for reviewing the files for any audit leads related to the contractor.

Eliminated Desk Reviews and Revised Adequacy Review Procedures

Table 3: Percentage of Proposals Sampled under Previous and New Procedures

Auditable dollar value	Sampling percentages for low risk proposals under previous criteria	Sampling percentages for low risk proposals under new criteria
\$1 million or less	33% ^a	1%
>\$1 million to \$15 million	33% ^a	5% ^b
>\$15 million to \$50 million	All proposals were audited	5% ^b
>\$50 million to \$100 million	All proposals were audited	10%
>\$100 million to \$250 million	All proposals were audited	20%
More than \$250 million	All proposals were audited	All proposals will be audited

Source: GAO analysis of DCAA procedures.

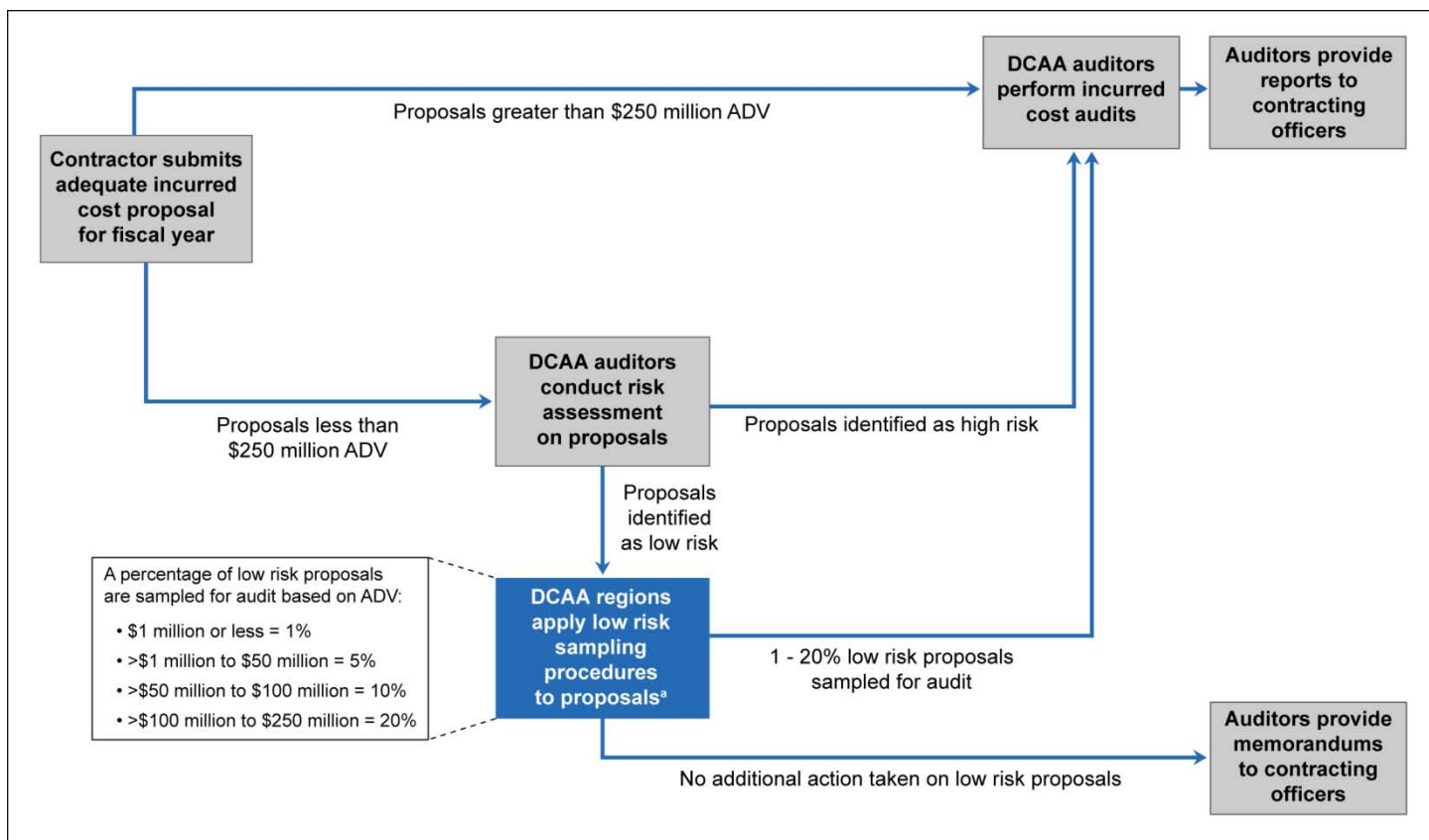
^aUnder the previous criteria, sampling percentages were 33 percent for all proposals \$15 million or less, not separately for the two categories (\$1 million or less; >\$1 million to \$15 million).

^bUnder the new criteria, sampling percentages are 5 percent for all proposals from greater than \$1 million to \$50 million, not separately for the two categories (>\$1 million to \$15 million; >\$15 million to \$50 million).

Under DCAA's risk-based initiative, low risk proposals that are not selected for audit are not subject to any further review, whereas previously all proposals not selected for audit were subject to desk reviews. Desk reviews included an evaluation of the proposal for unusual items and changes from prior year proposals, among other actions. Now, when a low risk proposal is not selected for audit, DCAA auditors issue memorandums to the contracting officers recommending that the contracting officer use his or her authority to determine the contractor's final indirect cost rates, which allows the contracting officer to proceed with closing the contract. However, in November 2011, DCAA issued revised guidance to determine whether a contractor's proposal is adequate, and DCAA officials explained that the revised adequacy review provides a more comprehensive determination that includes many areas previously covered in the desk review process.

A summary of DCAA's revised incurred cost audit procedures are outlined in figure 3.

Figure 3: DCAA's Revised Incurred Cost Audit Procedures



Source: GAO analysis of federal and DOD regulations and guidance.

^aProposals with an ADV of greater than \$100 million to \$250 million must have an incurred cost audit at least once every three years.

DCAA Has Not Yet Fully Developed Measures to Evaluate the Initiative's Results

By revising its policies and procedures and dedicating resources to incurred cost audits, DCAA estimates it will reduce its backlog and reach a steady state by 2016, which it defines as having two fiscal years of incurred cost proposals awaiting review. By randomly sampling low risk proposals, DCAA officials note that the possibility of an audit is still present, which is a deterrent for contractors to report inaccurate information. However, DCAA has not yet fully developed measures to evaluate the initiative's results and assess whether the changes will require further adjustments. For example, DCAA is planning to track the number of risk determinations completed, the numbers of proposals deemed high and low risk, and the number of audits completed. Further, DCAA regional offices will be responsible for monitoring risk

determinations on an ongoing basis to ensure that they are completed in a timely manner and to identify any field audit offices that have a significantly higher or lower percentage of high risk determinations than other field audit offices. However, DCAA has not determined how to assess whether the revised criteria for determining a proposal's risk level or the revised sampling percentages are appropriate or should be adjusted in the future. DCAA stated that they plan to reassess the initiative in about a year, but did not provide details on what would be assessed at that time. Internal control standards require the establishment of clear, consistent objectives and the identification and analysis of what measures will be used to determine if an agency is achieving those objectives.¹⁸

Additionally, it is too early to tell whether DCAA will achieve its goal of eliminating the backlog by 2016, in part because DCAA does not yet know how many proposals under \$250 million ADV will be determined low or high risk and its initial estimates have proven inaccurate. DCAA reports that its auditors have completed risk assessments on 13,522 contractor proposals that had an ADV of less than \$15 million—out of a universe of approximately 20,000 proposals—as of September 2012. Of 13,522 risk assessments completed, DCAA determined that 7,815 proposals were high risk, or about two-and-a-half times more than anticipated. DCAA determined that the number of high risk proposals is higher than expected because over 3,500 of those proposals belong to contractors with no incurred cost audit history. DCAA's backlog includes multiple proposals covering several fiscal years for some contractors. DCAA officials stated the agency plans to audit older proposals first, thus contractors' proposals for later years may become eligible for low risk status once an audit has been conducted for a single fiscal year and an audit history is established. DCAA's ability to reach a steady state by 2016 will also depend on whether DCAA completes its audits within anticipated time frames. However, DCAA was not able to complete the number of audits it planned to in 2012. Specifically, DCAA planned to address 4,065 incurred cost proposals in fiscal year 2012 by, for example, completing an audit or desk review, but the agency reported that it addressed 2,930 as of the end of September 2012.

¹⁸ [GAO/AIMD-00-21.3.1](#).

DOD's Efforts to Reduce Its Contract Closeout Backlog Is Hindered by Limited Data and Performance Metrics

DCAA's efforts to reduce its incurred cost backlog will remove one factor hindering efforts to close out flexibly priced contracts; however, DOD is also hindered by limited data and performance metrics on contract closeout efforts. The military departments generally do not have data on the extent or nature of their contract closeout backlog, while DCMA is missing key information that would allow it to identify contracts on which it could take action. Additionally, the military departments generally lack performance metrics on contract closeout. For example, in November 2012, the Army announced its intent to close 475,000 over-age contracts by September 2014, but was still in the process of having its commands identify interim goals and did not yet have a final detailed implementation plan, while the Navy and Air Force have no department-wide metrics. In contrast, DCMA has established two agency-wide performance metrics related to contract closeout with regular reporting to the head of the agency on progress in meeting goals. Our work identified some efforts at local contracting offices to focus on contract closeout, but DOD has made limited use of quick closeout procedures—a tool that can be used to expedite the closeout of flexibly priced contracts.

DOD Has Limited Data on Its Contract Closeout Backlog

Data on the extent and nature of the contract closeout backlog can help organizations identify or tailor approaches to address the backlog. However, we found that the military departments had difficulty providing reliable data on the size of their backlogs and did not have information on where the contracts were in the closeout process. For example, we requested data from each of the military departments on the number of contracts in the backlog, type of contract, and what contracting office was administering the contract. The military departments took the following steps to provide the data:

- The Army pulled data from its centralized data repository, but there were large discrepancies between the data provided by headquarters and data reported at the commands and local contracting offices. For example, according to the data provided by headquarters, one contracting office had about 30,000 over-age contracts, yet officials at the office reported about 3,700 over-age contracts.
- The Air Force also pulled data from its centralized data repository for one command, but the command had to verify the data with its local contracting offices and acknowledged it needed to make adjustments based on the input from those offices before providing the data to us. Air Force officials told us that providing the data for the remaining commands would require significant effort because they would need to go through a similar verification process.

-
- Navy officials told us they did not have a centralized data repository, so the Navy requested data from its local contracting offices.

At the local level, seven out of the nine contracting offices we spoke with collected some information about their over-age contracts, such as the total number of contracts in the backlog and the type of contracts, but the offices generally were unable to provide us with detailed information as to where the contracts were in the closeout process, such as the number awaiting a DCAA incurred cost audit.

DCMA collects data through its Mechanization of Contract Administration Services (MOCAS) system on where its over-age contracts are in the contract closeout process, but it is missing key information that would allow it to identify contracts that it could take action on. For example, DCMA's data showed that as of July 2012 the agency had approximately 36,000 contracts awaiting closeout, including 28,000 that were awaiting establishment of final indirect cost rates. However, of these 28,000 contracts, DCMA did not know how many were awaiting a contractor's submission of an adequate incurred cost proposal, a DCAA incurred cost audit, or final negotiation of rates. This information is important because it identifies who is responsible for moving the contract forward in the closeout process—for example, DCMA contracting officers may be able to advance the closeout of contracts awaiting final negotiation of rates. DCMA officials we spoke with thought that the majority of these contracts were awaiting DCAA's audit, and thus would be addressed by DCAA's initiative. In addition, DCMA's MOCAS system was missing data on the reasons why contracts are over-age for about 1,700 contracts.¹⁹ DCMA officials told us the agency recently enhanced its efforts to identify and close contracts within the agency's control due to an increase in the number of over-age contracts in fiscal year 2012. DCMA officials reported that specific categories of contracts are being targeted for closure, such as firm-fixed-price contracts with no outstanding obligations.

The limited visibility into the characteristics of the contract closeout backlog, particularly at the military departments, made it challenging for officials to fully assess the extent to which specific efforts to reduce the backlog would impact their over-age contracts. For example, we asked DOD officials their views on restoring the authority of the head of an

¹⁹The remaining 6,300 contracts were held up in other steps in the closeout process. For example, 1,200 contracts were waiting for the contractor to submit a final voucher.

agency to close out a contract that is administratively complete, was entered into 10 or more years ago, and has an unreconciled balance under \$100,000. Many DOD officials we spoke with at various levels within the military departments and within DCMA stated they did not believe the option would affect the backlog, as they did not believe their contracting offices would have many contracts to which this option would apply. For example, based on DCMA's over-age contract data, DCMA officials estimated that as of July 2012, only 85 of the approximately 36,000 contracts in their backlog would meet the criteria of the option. However, officials at the military departments, commands and local contracting offices that we asked generally could not provide specific numbers as to how many contracts this option would impact. Further, several officials noted that a similar temporary authority was granted in the mid-2000s that they believed was ineffective, in part because DOD established a process and administrative requirements that they termed burdensome.²⁰ For example, DFAS officials reported that the authority was only used to close out 14 contracts.

Similarly, when we asked how useful it would be if legislation authorized a contracting officer to waive final payment in a case where a contractor has gone out of business and cannot be reached, DOD officials reported that this situation occurs infrequently. Yet DOD officials at several locations we reviewed said that they did not have data readily available on how often they had encountered this situation. Further, some officials noted that a contracting officer can use the authority in the FAR to unilaterally close a contract for this purpose.²¹ Additionally, DCMA's guidebook outlines procedures that contracting officers use to close a contract where the contractor has gone out of business.

Military Departments Generally Did Not Have Performance Metrics to Measure Progress in Closing Out Contracts

Performance measures, which compare actual performance against planned results, can be an important tool in demonstrating leadership commitment and maintaining adequate internal controls. We found that the Army recently communicated a goal to its commands for closing over-age contracts, but the Navy and Air Force did not have established performance metrics for closing out contracts within their organization. In

²⁰The authority was granted in the National Defense Authorization Acts of 2004, 2005 and 2007.

²¹FAR § 42.705(c)(1).

November 2012, the Office of the Deputy Assistant Secretary of the Army (Procurement) sent an e-mail to its commands identifying a goal of closing over 475,000 over-age contracts by September 2014. The office requested that each command provide information on their over-age contracts by the end of November 2012, including identifying contracts that may be suitable to be grouped together and closed at the command level, such as low dollar contracts, and identifying contracts that fit into other priority categories, such as certain contracts with expiring funds. Further, the office directed the commands to establish monthly closeout goals and describe challenges that may impact the command's ability to meet the Army's September 2014 goal. According to an Army official, they have drafted an implementation plan for this effort, but the plan has not yet been approved. Although the Navy did not have department-wide performance metrics related to contract closeout, one Navy command established a goal of decreasing the contract closeout backlog from approximately 23,000 contracts to 13,000 contracts over fiscal year 2012, and reported it had exceeded that goal before the end of the year. Within the Air Force, headquarters officials told us in November 2012 that they plan to begin regular collection of data on contract closeout statistics starting in January 2013.

In contrast, DCMA had established two agency-wide performance measures related to contract closeout for contracts where they have been delegated contract administration responsibilities. For example, one of DCMA's closeout measures looks at the total number of over-age contracts in the agency, with a target of reducing the total number of over-age contracts by 10 percent during a fiscal year. The measures are reviewed at a number of levels within DCMA, including a briefing to the DCMA Director approximately twice a year, and monthly reviews at each of the contract management offices. When the targets for each measure are not met, DCMA officials conduct a root cause analysis to identify the reasons why, as well as to identify potential methods for addressing the issues.

While many DOD officials acknowledged that contract closeout is not a priority compared to other mission critical activities, we found some contracting offices were taking actions locally to address their contract closeout backlogs. For example, one Army contracting office made its contract closeout process more centralized, added two new staff, and tracked the number of contracts they closed. Officials at this office reported that they closed over 14,000 of a reported 20,000 low dollar firm-fixed-price contracts in its backlog over the past year. Further, we found four contracting offices established a contract closeout team whose work

is focused on contract closeout activities. Officials from three of these offices noted that their office prioritizes closing out contracts when funds are close to canceling to preserve funds for other uses.

Further, DOD has established a contract with the AbilityOne program for contract closeout support services to help address some of the contract closeout backlog. According to DOD officials, this contract is limited to closing firm-fixed-price contracts across the department, whether over-age or not.²² AbilityOne representatives reported that the contractor has already provided contract closeout support services for over 50,000 contracts across DOD. DOD stated that using AbilityOne allows contracting officers to focus on other duties and mission-critical work such as awarding contracts; however, some DOD officials noted limitations, including the administrative burden on the contracting officer to locate all appropriate documentation to forward to the AbilityOne contractor, and ensuring AbilityOne staff have the proper clearance and access for the contractors. While AbilityOne's efforts are currently limited to firm-fixed-price contracts, senior DOD officials told us they are looking into the feasibility of contracting with AbilityOne for contract closeout services on flexibly priced contracts.

DOD Organizations Made Limited Use of Quick Closeout Procedures

Our work found that DCMA and the contracting offices we reviewed made only limited use of quick closeout procedures. For example, even though DCMA has a policy, based on a FAR deviation, that allows for broader use of quick closeout procedures than what is allowed under the FAR, and DCMA's guidance recommends that contracting officers use quick closeout where applicable, the two DCMA contract management offices we reviewed made little or no use of quick closeout procedures.²³ Officials at DCMA headquarters and one contract management office said they were unsure why quick closeout is not used more often. Officials at the other DCMA contract management office we spoke with told us one reason they had not made more use of DCMA's policy related to quick

²²The AbilityOne program provides career opportunities for people who are blind or have severe disabilities, including service-disabled veterans. The program also trains and employs wounded veterans to conduct contract closeout activities.

²³DCMA's guidance states that when it becomes apparent that there will be a delay in the settlement of rates, it is recommended that contracting officers use quick closeout procedures. The guidance goes on to say that quick closeout procedures should be the first area looked at when deciding how to close a contract.

closeout procedures is that DCMA did not define what can be considered a compelling reason to waive an audit until December 2011. Further, once they started to assess eligibility, this office encountered challenges in identifying contractors that they considered to be eligible for the quick closeout procedure. Specifically, the office initially identified 1,489 contracts with 32 contractors that may be eligible for quick closeout procedures. However, after further analysis, officials reported that 463 contracts with 7 contractors were deemed potentially eligible. Contractors were excluded from eligibility due to issues such as contractor billing problems, DCAA concerns about the contractor, or contractor delays in submitting an incurred cost proposal.

Similarly, none of the nine military department contracting offices reported using quick closeout procedures currently, although three reported minimal use in the past. For example, one contracting office estimated using quick closeout procedures for about 40 to 50 contracts in fiscal years 2010 and 2011. Officials at two other contracting offices reporting use of quick closeout on a handful of contracts in the past, but are not making use of it now. With regard to the efficacy of the May 2011 change to the FAR that was intended, in part, to increase the use of quick closeout, officials at the two contracting offices that previously used quick closeout procedures reported that the May 2011 change reduced the number of eligible contracts by including direct costs in the eligibility criteria. Officials from one of these contracting offices explained that the previous language allowed the contracting officer to waive the dollar threshold based on a risk determination. Since the current language removed the waiver, officials explained that the contracting officer is no longer able to make a business decision for contracts above the dollar threshold to determine an acceptable level of risk.

DCMA and contracting officials we interviewed also noted that other challenges to the use of quick closeout procedures included a lack of audit history by which to determine what a contractor's rates should be. DOD officials told us there was sometimes a reluctance to use quick closeout procedures because they are uncertain of the risk they are taking on and concerned that their decisions may be questioned later by others.

During our interviews with DOD officials, we asked about the advisability and feasibility of authorizing a contracting officer, in consultation with DCAA, to waive the requirement for an audit in the case of a low risk, low cost contract to assist in closing out contracts—one of the options we were asked to consider in our review. Officials throughout DOD—at

DCMA, military commands, military department contracting offices, and others—told us they believed this option was similar to quick closeout procedures, a tool already available to them.

Conclusions

DOD has fallen far behind in closing out its contracts, in part due to the large backlog of incurred cost audits that must be performed by DCAA. DCAA has recognized that completing the volume of these audits, as well as other high-priority audits, using its traditional approach exceeds the capacity of its resources. In response, DCAA launched a risk-based approach to focus its resources on audits that are considered to be high risk or high dollar value. Such an approach appears prudent and shows promise, but its success will depend upon reducing the audit backlog in a way that protects the taxpayers' interests. DCAA, however, has not developed a plan with measures to assess progress toward achieving these goals. DCAA must ensure that the key changes to its criteria and procedures—such as increasing thresholds for audit, revising its risk determination criteria, and decreasing sampling percentages for low risk proposals—adequately direct resources to audits that will provide the greatest benefit to the taxpayer. Without a plan that includes appropriate measures, DCAA will not be well-positioned to assess whether the initiative is achieving its goals.

Reducing the incurred cost audit backlog should enable more flexibly priced contracts to be closed out, but the extent to which it will do so is uncertain. As there is not a one-to-one relationship between an incurred cost audit and a specific contract, and there are additional steps that need to be taken to close a contract, there is likely to be a lag in closing out contracts even if DCAA is successful in its efforts. Within the military departments, limited data on the extent of the backlog or the reasons why contracts are in the backlog hinders their ability to develop targeted approaches, with goals and performance metrics, to address over-age contracts. The Army is just starting to collect the information necessary to determine if it can realistically meet its goal of closing over-age contracts and has not issued an implementation plan. The Navy and the Air Force, while facing similar data issues, have no department-wide performance metrics. Even DCMA, which does have performance measures in place as well as some information on where the contract is in the closeout process, has incomplete information on who has responsibility for moving the contract forward in the closeout process. One technique—the use of quick closeout procedures—has been available for a number of years, but we found little evidence that any organization has made significant effort to use it, either before or after the May 2011 change in federal

regulations. Until DOD prioritizes closing contracts in a timely fashion and underscores the need to do so by improving the availability of accurate data and establishing performance measures, it will not see a significant reduction in its contract closeout backlog.

Recommendations for Executive Action

To improve DCAA's ability to assess whether its incurred cost backlog initiative is achieving the objectives of reducing the incurred cost audit backlog while continuing to protect the taxpayer's interests, we recommend that the Director, DCAA, develop a plan that includes time frames and measures to assess progress towards achieving its objectives, and as appropriate, to identify how it will assess whether the changes in DCAA's procedures and criteria are appropriate or require further revisions.

To increase visibility and enhance management attention on closing out contracts within their departments, we recommend that the Secretaries of the Navy and Air Force, respectively, develop baseline data and performance measures for closing out contracts, including consideration of the use of quick closeout procedures, as appropriate.

To facilitate the closeout of contracts within the Army, we recommend the Secretary of the Army ensure that the Army's contract closeout implementation plan includes baseline data and performance measures, and includes consideration of the use of quick closeout procedures, as appropriate.

To enable DCMA to better identify contracts that may be closed out, we recommend that the Director, DCMA, take steps to ensure the data in DCMA's contract information system on who has responsibility for moving the contract forward in the closeout process is complete.

Agency Comments and Our Evaluation

DOD provided written comments on a draft of this report. DOD concurred with the four recommendations and identified a number of ongoing and planned actions to address them. For example, DCAA stated that by March 2013 it will develop a more detailed plan to monitor and assess its progress towards achieving the objectives of its initiative. DCAA stated that this plan will include time frames and measures to determine whether its current criteria and procedures will require future modification. Further, DCAA identified several factors that this plan will include, such as an analysis of high risk determinations and audit results to determine if some criteria are better indicators of risk than others and an analysis of DCAA's

return on investment to determine if revisions to the sampling variables are needed.

Each of the military departments identified actions that they would take to increase visibility and management attention on closing out contracts within their departments. For example, the Navy plans to collect data and internal policies and procedures on closing out contracts, including the use of quick closeout procedures, from its contracting activities as an initial step developing Navy-wide baseline data and performance measures for closing out contracts. The Air Force stated that it plans to place additional emphasis on aging contracts at a joint forum focused on high priority issues between DCMA, DCAA, and the departments. The Army concurred with our recommendation and reiterated its goal of eliminating approximately 475,000 over-age contracts by the end of fiscal year 2014, but did not provide additional details on how baseline data, performance measures, or consideration of the use of quick closeout procedures would be integrated into its detailed implementation plan. We believe that doing so would facilitate the Army's efforts and enable it to assess progress.

In response to our recommendation to better identify contracts that may be closed out, DCMA plans to begin requiring the use of a code within its MOCAS system that will clearly identify who is responsible for the next step in the closeout process, and to ensure the code is properly entered into the system. DOD's comments are reprinted in appendix II.

We are sending copies of this report to the Secretary of Defense; the Secretaries of the Army, Navy, and Air Force; the Director, Defense Contract Audit Agency; the Director, Defense Contract Management Agency; appropriate congressional committees; and other interested parties. This report will also be available at no charge on GAO's website at <http://www.gao.gov>.

If you or your staff have any questions concerning this report, please contact me at (202) 512-4841 or by e-mail at dinapolit@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix III.

A handwritten signature in black ink, appearing to read "Timothy J. DiNapoli". The signature is fluid and cursive, with the first name "Timothy" and last name "DiNapoli" clearly legible.

Timothy J. DiNapoli
Acting Director
Acquisition and Sourcing Management

Appendix I: Objectives, Scope, and Methodology

The Senate Armed Services Committee report accompanying the National Defense Authorization Act for Fiscal Year 2012 directed us to review the Defense Contract Audit Agency's (DCAA) criteria and procedures for conducting incurred cost audits and recommend steps DCAA could take to reduce the backlog, and to consider the feasibility and advisability of three options aimed at reducing the contract closeout backlog.¹ The three options we were asked to consider were (1) restoring the authority of the head of an agency to close out a contract that is administratively complete, was entered into 10 or more years ago, and has an unreconciled balance of less than \$100,000; (2) authorizing the contracting officer, in consultation with DCAA, to waive the requirement for an incurred cost audit in the case of a low risk, low-cost contract; and (3) authorizing the contracting officer to waive final payment in a case where the contractor has gone out of business and cannot be reached. It also asked us to assess the efficacy of a May 2011 change to the Federal Acquisition Regulation (FAR) that was intended, in part, to increase the use of quick closeout procedures. In response, this report addresses (1) DCAA's efforts to reduce the backlog of incurred cost audits, and (2) the challenges the Department of Defense (DOD) faces in addressing the contract closeout backlog. Included within the scope of the second objective was a consideration of the three options outlined in the Committee report as well as the use of quick closeout procedures.

To conduct our work for each objective, we reviewed relevant sections of the FAR, including FAR Subpart 4.804, Closeout of Contract Files and FAR Subpart 42.1, Contract Audit Services, and the Defense Federal Acquisition Regulation Supplement (DFARS), including DFARS Subpart 242, Contract Administration and Audit Services. We also reviewed DOD policies, such as the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics memorandum on Increasing Contracting Opportunities with the AbilityOne Program. We also reviewed prior GAO and DOD Inspector General reports pertaining to challenges at DCAA and the Defense Contract Management Agency (DCMA), and contract closeout at DOD, including contract closeout in a contingency environment. And finally, we reviewed GAO's Standards for Internal Controls in the Federal Government.²

¹S. Rep. 112-26, at 153 (2011).

²GAO, *Internal Control: Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November, 1999).

To assess DCAA's efforts to reduce the backlog of incurred cost audits, we reviewed applicable sections of federal regulations and DCAA's Contract Audit Manual to identify criteria and procedures for selecting and conducting incurred cost audits. We obtained and reviewed data from DCAA's management information system on the agency's incurred cost audit backlog. To assess the reliability of DCAA's data on its incurred cost audit backlog, we reviewed related documentation, interviewed knowledgeable agency officials, looked for obvious inconsistencies in the data, and verified the accuracy of the data when necessary. From these efforts, we believe the information obtained is sufficiently reliable for this report. We also reviewed documentation on DCAA's incurred cost audit initiative, such as DCAA guidance on its revised criteria and procedures for risk assessment, agency memorandums related to the timing and implementation of the new sampling procedures, new forms for documenting risk determinations, and data on which proposals were selected for audit. We reviewed analyses and projections DCAA used to establish its goal of becoming current on incurred cost audits by 2016. We interviewed senior DCAA officials responsible for the incurred cost audit initiative, and DCAA auditors from three field offices to obtain a better understanding of the process and considerations for determining risk for the contractor's incurred cost proposals. We selected the three DCAA field offices that had completed the largest number of risk assessments under the new incurred cost audit initiative as of September 2012. We also interviewed officials at Defense Procurement and Acquisition Policy (DPAP) and DCMA to get their perspective on DCAA's incurred cost audit initiative.

To identify the challenges DOD faces in addressing the contract closeout backlog and to assess the efficacy of the May 2011 change to the FAR pertaining to quick closeout procedures, we reviewed applicable sections of the FAR, including FAR Subpart 42.3, Contract Administration Office Functions and FAR Section 42.708, Quick Closeout Procedures, and DFARS Subpart 242.3, Contract Administration Office Functions. We also reviewed Air Force, Navy, Army, and DCMA guidance, as well as DCMA policy on contract closeout and quick closeout procedures, such as the agency's March 2012 closeout instructions and DCMA's deviation to the quick closeout procedures. We obtained available data from the Army, Navy, and Air Force, five commands and nine contracting offices within the military departments. We selected the commands and contracting offices based on factors such as the total reported volume of over-age contracts and interviews with senior DOD officials (see table 4). We determined that the data reported by the military departments was sufficient for our purposes of selecting which commands and contracting

offices to review, but did not take steps to assess the reliability of the data collected from the local contracting offices.

Table 4: Military Department, Command, and Contracting Offices GAO Reviewed

Military department	Command	Contracting office
Army	Army Medical Command	U.S. Army Medical Research Acquisition Activity, Fort Detrick, Maryland
	Army Materiel Command/Army Contracting Command- Aberdeen Proving Ground	Army Depot, Tobyhanna, Pennsylvania
		Army Research Office, Durham, North Carolina
Navy	Naval Sea Systems Command	Southwest Regional Maintenance Center, San Diego, California
		Supervisory Shipbuilding, Groton, Connecticut
	Naval Facilities Engineering Command	Atlantic and Mid-Atlantic, Norfolk, Virginia
Air Force	Air Force Materiel Command	Specialty Acquisitions Center, Port Hueneme, California
		Electronic Systems Center- Hanscom Air Force Base, Massachusetts
		Warner Robins- Air Logistics Center, Robins Air Force Base, Georgia

Source: GAO.

We collected and analyzed available data and documentation on over-age contracts from DCMA headquarters and the two DCMA contract management offices with the largest volume of over-age contracts—located in Manassas, Virginia and Baltimore, Maryland. To assess the reliability of DCMA’s data, we reviewed related documentation, interviewed knowledgeable agency officials, looked for obvious inconsistencies in the data, and verified the accuracy of the data when necessary. We also compared the data received from DCMA headquarters to the data that we received from Manassas and Baltimore. From these efforts, we believe the information we obtained is sufficiently reliable for this report. We also interviewed officials from DCMA headquarters and the two contract management offices. Further, we interviewed and collected documentation from officials at DPAP, DCAA, and the Defense Finance and Accounting Services; and from Army, Navy, and Air Force officials at the headquarters and command level, as well as individual contracting offices. We interviewed two contractor industry associations as well as a DOD contractor to obtain their views on the incurred cost audit and contract closeout backlogs.

To address the options outlined in the Committee report, we reviewed applicable laws, such as the National Defense Authorization Acts of Fiscal Years 2004, 2005, and 2007, which had authorities similar to one we were asked to review, and related agency policies and guidance, such as DCMA's contract closeout guidebook. We also solicited input about the availability and potential usefulness of the options in our interviews with DCAA, DCMA, military departments' headquarters, commands, and local contracting offices, military departments' general counsel, DFAS, and contractor representatives.

We conducted this performance audit from February 2012 to December 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Department of Defense



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

OFFICE OF THE DIRECTOR

December 14, 2012

Mr. Timothy J. DiNapoli
Acting Director, Acquisition and Sourcing Management
U.S. Government Accountability Office
441 G Street NW, Washington DC 20548

Dear Mr. DiNapoli:

This is the Department of Defense (DoD) response to the GAO Draft Report, GAO-13-131, DEFENSE CONTRACTING: DOD Initiative to Address Audit Backlog Shows Promise, but Additional Management Attention Needed to Close Aging Contracts, dated November 27, 2012 (GAO Code 121036).

Thank you for the opportunity to respond to the subject draft report. Our response to the draft report recommendations are shown below:

RECOMMENDATION 1: The GAO recommends that the Director, Defense Contract Audit Agency, develop a plan that includes timeframes and measures to assess progress towards achieving its objectives, and as appropriate, to identify how it will assess whether the changes in Defense Contract Audit Agency's procedures and criteria are appropriate or require further revisions.

DoD RESPONSE: Concur. DCAA implemented the low-risk sampling initiative in September of 2012 and will evaluate the initiative after sufficient experience with the sampling results has been gathered. DCAA will document the plan to monitor and assess the progress towards achieving the objectives of the low-risk incurred cost-sampling initiative. DCAA's plan will include timeframes and measures to determine whether current procedures and criteria will require future modification. Examples of some of the factors the plan will include are:

- Analysis of completed audits to determine if the results of audit correlate with the initial risk determination;
- Analysis of return on investment by dollar strata to determine if revisions to sampling variables are needed (e.g., dollar thresholds, sampling percentages);
- Analysis of the high-risk determinations and audit results to determine if some criteria are better indicators of risk than others; and
- Analysis of reasons for questioned costs on audits to determine if there are better indicators of high risk;

- Monitoring progress on reducing the incurred cost backlog and ensuring that resources saved under this initiative are applied to high-risk/high-payback areas.

DCAA will continue to coordinate with the Defense Procurement and Acquisition Policy and the GAO on efforts to reduce the incurred cost backlog. It will also refine the criteria and provide a more detailed assessment plan by March 2013.

RECOMMENDATION 2: The GAO recommends that the Secretaries of the Navy and Air Force, respectively, develop baseline data and performance measures for closing out contracts, including consideration of the use of quick closeout procedures, as appropriate.

DoD RESPONSE: The Department of the Navy (DON) concurs with the recommendation to develop baseline data and performance measures for closing out contracts, and to consider the use of quick closeout procedures, as appropriate. The Deputy Assistant Secretary of the Navy for Acquisition and Procurement (DASN (AP)) will issued a memorandum to DON contracting activities requesting that they remain diligent in their efforts to close out overage contracts. DASN (AP) will collect DON contracting activities' data and internal policies and procedures on closing out contracts, including the use of quick closeout procedures. This will be the initial step for collecting the data needed to develop the DON baseline data and performance measures for closing out contracts. Moreover, closing contracts within required timeframes has been a recurring agenda item for our quarterly DON Naval Contracting Council (NCC) meetings. Based on this GAO recommendation, we will consider whether the subject should be a regular agenda item for our quarterly NCC meetings.

The Air Force concurs with the recommendation to develop baseline data and performance measures for closing out contracts. The Air Force Deputy Assistant Secretary (DAS) (Contracting) will be initiating a task with the field contracting centers to begin collecting data in early January 2013. Additionally, Air Force senior management is focused on addressing issues that preclude timely closeout of contracts. Since 2011, the Air Force and other services have been participating in a DoD Chaired forum known as the "DCMA/DCAA Top 10." The focus of this forum is to collectively work high priority joint issues between DCMA, DCAA and the services. One of the recurring priorities is incurred cost audits and their impact to aging contracts, especially those with cancelling and/or expiring funds. In light of the report, the Air Force will place additional emphasis on aging contracts at this joint forum to ensure each service is appropriately working cross-agency issues to help improve DCMA contract closeout performance metrics and service metrics.

The Air Force concurs with the recommendation to use quick closeout procedures, as applicable. Air Force Contracting will use various communications to inform Senior Contracting Leaders and Air Force contracting personnel about quick closeout procedures, to the maximum extent possible, and consistent with the Federal Acquisition Regulation.

RECOMMENDATION 3: The GAO recommends that the Secretary of the Army ensure that the Army's contract close-out implementation plan includes baseline data and performance measures, and includes consideration of the use of quick closeout procedures, as appropriate.

DoD RESPONSE: Concur. The Army is establishing a Contract Closeout Task Force (C2TF) to oversee the closing of overage contracts within its portfolio. The C2TF goal is zero overage balance by 30 September 2014 when measured against the FY12 baseline of 475,178 overage contracts. The closeout priorities are (a) 1st through 5th year overage contracts with expiring funds and unliquidated obligations (ULOs); and (b) 1st through 5th year overage contracts with no expiring funds and no ULOs. Buying Commands are required to submit their Contract Closeout Plans by 30 November 2012. These plans will identify their goals and strategy for eliminating their overage backlog. Also, the Commands will be allowed to identify which contracts are eligible for mass closeout procedures in accordance with established business rules. The Office of the Deputy Assistant Secretary of the Army (Procurement) will monitor the Plans to ensure that goals are being accomplished. In accordance with Federal Acquisition Regulation (FAR) 42.708, Quick Closeout procedures will be considered when appropriate.

RECOMMENDATION 4: The GAO recommends that the Director, Defense Contract Management Agency, take steps to ensure the data in Defense Contract Management Agency's contract information system on who has responsibility for moving the contract forward in the closeout process is complete.

DoD RESPONSE: Concur. The DCMA Administrative Contracting Officer (ACO) leads, and is ultimately responsible for, the contract closeout process. The ACO relies on and coordinates with various functional specialists to complete closeout, including DCMA personnel, DFAS (or other appropriate payment offices), Buying Activity personnel, DCAA (or other audit agencies), and the contractor, as necessary. The primary code used by the ACO to identify the reason why a contract is over-age in the Mechanization of Contract Administration Services (MOCAS) system does not always clearly identify who is currently responsible for the next step in the process. MOCAS already has a field for entry of a secondary code that will more clearly identify who is responsible for the next action. In response to the GAO recommendation, DCMA will begin requiring the use of the secondary code and ensure the code is properly entered in the MOCAS system to identify who has responsibility for moving the contract forward in the closeout process.

Questions regarding this letter should be directed to Mr. Joe Garcia, Executive Officer, at (703) 767-3265 or e-mail joe.garcia@dcaa.mil.


Patrick J. Fitzgerald
Director

Appendix III: GAO Contact and Staff Acknowledgments

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Staff Acknowledgments

In addition to the contact named above Tatiana Winger, Assistant Director; Arkelga Braxton, Virginia Chanley, Nicole Dery, John Krump, Janet McKelvey, Anh Nguyen, Robert Swierczek, and Omar Torres made key contributions to this report.

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